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CITATIONS

563047- 43——1

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 492

THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINION BELOW

The majority (R. 63–88) and minority (R. 88–92) opinions of the United States Board of Tax Appeals are reported in 44 B. T. A. 293. The opinion of the Circuit Court of Appeals (R. 128–133) is reported in 137 F. 2d 623.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 18, 1943. (R. 133–134.) The petition for a writ of certiorari was filed Novem-

ber 17, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. During the taxable year, 1933, the taxpayer, a mutual life insurance company, maintained reserves for its supplementary contracts not involving life contingencies. Do these reserves constitute "reserve funds required by law" within the meaning of Section 203 (a) (2) of the Revenue Act of 1932, which authorizes percentage deductions in respect of such funds?

2. If that question be answered in the negative, then did the court below correctly hold that the taxpayer is not entitled, under Section 203 (a) (8) of the Revenue Act of 1932, to deduct excess interest dividends paid during the year under such supplementary contracts?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix, *infra,* pp. 10–15.

STATEMENT

The taxpayer is a mutual life insurance company engaged in the business of issuing life insurance and annuity contracts, transacting that business in every state except Texas. More than 50 percent of its total reserve funds have been held for fulfillment of its life insurance and an-

nuity contracts. (R. 67.) During and prior to 1933, the taxable year, the taxpayer issued life insurance policies which gave to the insured, and in some cases to the beneficiary, the right to require it to apply the net sum due under the policy upon its maturity in accordance with one of the optional modes of settlement set up in stipulation Exhibit D, which may be found on page 118A of the record. The pertinent provisions of that exhibit are as follows:

> 1. Deposit option: Left on deposit with the Society at interest guaranteed at the rate of 3% per annum, with such Excess Interest Dividend as may be apportioned.
>
> 2. Instalment option (fixed period): Paid in a fixed number of equal annual, semi-annual, quarterly or monthly instalments as set forth in the following table.
>
> * * * * *
>
> 4. Instalment option (fixed amount): Paid in equal annual, semi-annual, quarterly or monthly instalments of such amount as may be agreed upon until the net sum due under this policy together with interest on the unpaid balances at the rate of 3% per annum, and such Excess Interest Dividends as may be apportioned, shall be exhausted, the final payment to be the balance then remaining with the Society. If the interest and Excess Interest Dividend for any year shall be in excess of the instalments payable in such year, then the total amount of the instalments for the subse-

quent year shall be increased by the amount of such excess.

Excess interest dividend: The foregoing Options are based upon an interest earning of 3% per annum; but if in any year the Society declares that funds held under such Options shall receive interest in excess of 3% per annum, the interest under Option 1, the amount of instalment under Option 2, the amount of income during the fixed period of five, ten or twenty years under Option 3 and the funds held under Option 4, shall be increased for that year by an Excess Interest Dividend as determined and apportioned by the Society.

Contracts arising from the exercise of such options are generally known as supplementary contracts not involving life contingencies (R. 69).

The Board of Tax Appeals sustained the Commissioner's action in disallowing deductions in respect of supplementary contract reserves and also held that the taxpayer was entitled to deduct only a portion of the amounts claimed as interest paid, namely, the guaranteed interest at the rate of three per cent paid pursuant to Option 1 and the portion of such guaranteed interest paid under Options 2 and 4, where the beneficiary elected the option after maturity of the policy (R. 80, 82–84). The court below modified the order of the Board so as to allow the deduction of guaranteed interest paid under settlement options exercised by the insured, and affirmed the order in all other respects (R. 132–133).

ARGUMENT

The court below decided correctly the two points raised by the taxpayer in its application for a writ of certiorari, and there is no occasion for further review. These points are whether the taxpayer is entitled to a reserve deduction under Section 203 (a) (2) of the Revenue Act of 1932 (Appendix, *infra*), and, as an alternative, whether the taxpayer is entitled under Section 203 (a) (8) of the same Act (Appendix, *infra*) to a deduction for excess interest paid.

1. The reserves were carried to provide for the payment of matured life insurance policies and not to meet life contingencies. The court below correctly interpreted the decisions of this Court (*Helvering* v. *Inter-Mountain Life Ins. Co.*, 294 U. S. 686; *Helvering* v. *Illinois Ins. Co.*, 299 U. S. 88; *Helvering* v. *Oregon Ins. Co.*, 311 U. S. 267) to hold that Congress has not given the privilege of deduction to values that have as little relation to contingencies of life insurance as those involved in the supplementary contract reserves under consideration. In the view that this Court has so held even where the earlier regulations of the Treasury Department allowed such deductions as are claimed here, the court found it unnecessary to discuss Regulations 77, promulgated under the Revenue Act of 1932, Article 971 (Appendix, *infra*). (R. 130–132.) This, we submit, was a correct treatment of the issue.

Despite this disposition by the court below, the taxpayer interjects the regulations into the case and contends (Pet. 6–9; Br. 16–23) that the decision below conflicts with *Helvering* v. *Reynolds Co.*, 306 U. S. 110; and *Helvering* v. *Oregon Ins. Co., supra.* The basis of the contention is that under the regulations existing during the tax year 1933 and prior thereto (Art. 681, Treasury Regulations 62, 1921 Act; Art. 681, Treasury Regulations 65, 1924 Act; Art. 681, Treasury Regulations 69, 1926 Act; Art. 971, Treasury Regulations 74, 1928 Act; Art. 971, Treasury Regulations 77, 1932 Act) deductions were allowed in respect of reserves for supplementary contracts such as here involved; and that the 1935 amendments to the regulations (T. D. 4615, XIV–2 Cum. Bull. 310, Appendix, *infra*), expressly denying such deductions, could not operate retroactively under the ruling in the *Reynolds Co.* case. But we do not understand that case to be at variance with the rule that an invalid regulation may be disregarded (*Manhattan Co.* v. *Commissioner,* 297 U. S. 129; *Koshland* v. *Helvering,* 298 U. S. 441), and we submit that the earlier regulations purport to allow a deduction not authorized by the law as interpreted in the relevant decisions of this Court (*Helvering* v. *Inter-Mountain Life Ins. Co., supra; Helvering* v. *Illinois Ins. Co., supra; New York Ins. Co.* v. *Edwards,* 271 U. S. 109). Indeed, the change in the regulations was precipitated by

this Court's decision in the *Inter-Mountain* case (Cf. R. 131).

The instant case is distinguishable from *Helvering* v. *Oregon Ins. Co., supra,* where this Court held the regulations could not be retroactively amended so as to deprive the company of a deduction in respect of disability reserves, allowable under the earlier regulations. In so holding this Court (p. 271) expressly distinguished its previous decisions in the *Inter-Mountain Life Ins. Co.* and *Illinois Ins. Co.* cases on the ground that they rested upon the conclusion that the investment fund features had no relation to the insurance risks, while in combined life, health and accident policies, the health and accident reserves are based upon contingencies of the commencement and continuance of disability and have a direct and inseparable relationship to the very insurance contracts which bring the issuing company under a special tax scheme. The reserves here in controversy are different in character from the reserves dealt with in the *Oregon Ins. Co.* case and the court below correctly so held (R. 131–132).

2. As to the alternative claim for a deduction in respect of excess interest dividends paid during the taxable year, the court below took the view (R. 133) that a payment which may be made or withheld at the will of the directors of the company cannot be regarded as a payment of interest within the strict construction which must

be adopted in construing an exemption statute. This seems obviously correct and is in accordance with the decision of the Third Circuit in *Penn Mut. Life Ins. Co.* v. *Commissioner,* 92 F. 2d 962, 970, which necessarily overruled the earlier decision of the same court in *Lederer* v. *Penn Mut. Life Ins. Co.,* 258 Fed. 81, affirmed on another issue, 252 U. S. 523, to the extent that they may be considered inconsistent. However, the decision below does seem to conflict with *Commissioner* v. *Lafayette Life Ins. Co.,* 67 F. 2d 209 (C. C. A. 7th). In view of this we would ordinarily not oppose the granting of certiorari to resolve the conflict. But the point has been disposed of for 1942 and later years by Section 162 (a) of the Revenue Act of 1942, which provides for the inclusion of excess interest dividends such as are here involved within the definition of interest paid. See S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 146–147. And although the point is open as to earlier years (R. 133), still we doubt whether it is of sufficient importance to justify consideration by this Court. The Bureau of Internal Revenue advises that a check of its records does not disclose any substantial number of pending cases involving the right of an insurance company to deduct either guaranteed interest or excess interest dividends.

CONCLUSION

The decision is correct as to the issues here involved; the petition should be denied. If, how-

ever, the Court should believe review as to the excess interest dividends warranted, certiorari on this petition should be limited to that issue.

Respectfully submitted.

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DECEMBER 1943.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General Rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) *Reserve Funds.*—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, shall be allowed, in addition to the above, a deduction of 3¾ per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

* * * * *

(8) *Interest.*—All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations

of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title.

* * * * *

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 971 [as originally adopted]. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four per cent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per cent shall be substituted for 4 per cent. The reserve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the State insurance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance.

In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized

tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. The deduction in respect of such reserve funds (not required by law) is 3¾ per cent of the mean of such reserve funds held at the beginning and end of the taxable year. Reserves maintained to provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, but the reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7–11 of the liability page of the annual statement for life insurance companies, and items 16–19 and 26 of the liability page of the annual statement for miscellaneous stock companies, if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered.

ART. 971 [as amended by T. D. 4615, XIV–2 Cum. Bull. 310 (1935)]. *Tax-exempt interest and reserve funds.*—Under paragraphs (1) and (2) of section 203 (a), life insurance companies are entitled to deduct from gross income:

* * * * *

(2) Four per cent of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per cent shall be substituted for 4 per cent.

In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; annual and deferred dividends; accrued but unsettled

policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. The deduction in respect of such reserve funds (not required by law) is 3¾ percent of the mean of such reserve funds held at the beginning and end of the taxable year.

ART. 975 [as originally adopted]. *Other deductions.*—* * *

* * * * *

(3) The deduction allowed by section 203 (a) (8) for interest on indebtedness is the same as that allowed other corporations by section 23 (b) (see article 141), but this deduction includes item 17 of the disbursement page of the annual statement of life insurance companies to the extent that interest on dividends held on deposit and surrendered during the taxable year is included therein. Dividends left with the company to accumulate at interest are a debt and not a reserve liability.

Article 975, as amended by T. D. 4615, *supra,* is the same as the foregoing except that it also includes a new paragraph numbered (4) at the end thereof, as follows:

(4) If a life insurance company pays interest on the proceeds of life insurance policies left with it pursuant to the provisions of supplementary contracts, not involving life contingencies, or similar contracts, the interest so paid shall be allowed as a deduction from gross income, except that such deduction shall not be allowed in respect of interest accrued in any prior taxable year to the extent that the company has had the benefit of a deduction of 4 percent or 3¾ percent, as the case may be, of the mean of the company's liability on such contracts, by the inclusion of such liability in its reserve funds.

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